

8 Key Elements for a Successful Lift-Out Transaction

Client Alert | October 12, 2021

Over the past few years we have observed a trend in companies seeking to outsource (and monetize) certain core, best-in-class processes. These transactions, dubbed “lift-outs”, include examples such as insurance companies lifting-out their insurance claims processing capabilities, medical device companies lifting-out their medical device manufacturing capabilities, and pharmaceutical companies lifting-out their research and development capabilities.

While the benefits of these transactions are potentially significant, lift-outs are complex and require a broad array of legal disciplines, such as technology, corporate, tax, privacy, real estate, intellectual property, and employment law specialists, often in multiple jurisdictions. They also demand a significant amount of effort and advance planning in order to address issues such as pricing, governance, change management, limits on liability, indemnification obligations, intellectual property rights, termination rights, and exit rights, among others. As a result, successful lift-out transactions require robust legal expertise in order to document and support the long term goals, opportunities and arrangements of the parties.

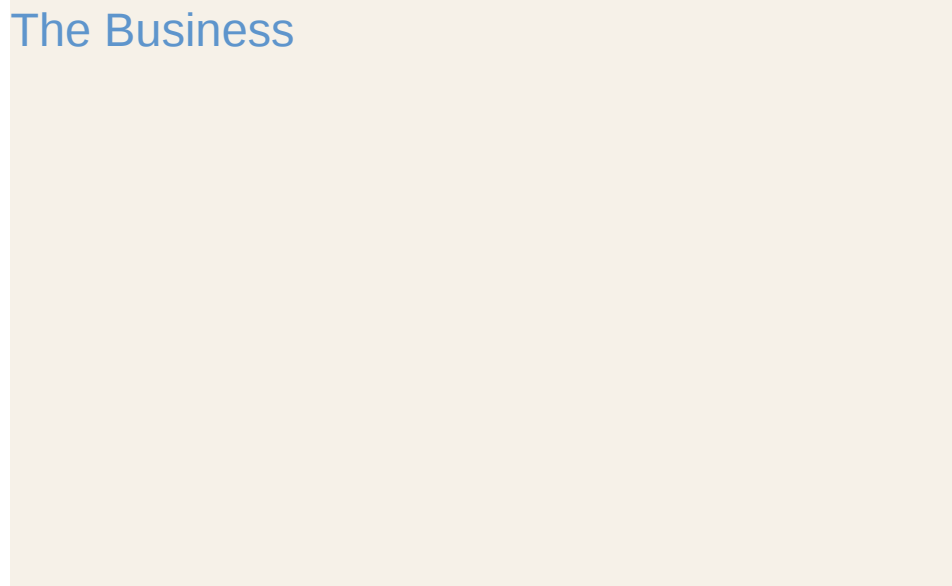
From a legal perspective, many of the challenges that arise from lift-out transactions stem from the fact that lift-outs are a hybrid of several better known transactions, namely IT outsourcing transactions, business process outsourcing transactions and carve-out divestiture transactions. While lift-outs have elements that on their face look familiar to either an outsourcing attorney or M&A attorney, these elements and issues are often not addressed in a traditional manner. As such, understanding how to address these elements is critical to a successful lift-out transaction. This alert will discuss several of these key elements.

Related People

[Daniel Angel](#)

[Dennis J. Friedman](#)

The Business



service provider’s other customers). This is often the most difficult aspect of a lift-out transaction because the internal capabilities being acquired are unlikely to have been operated as a separate business. Moreover, these internal capabilities are rarely even housed within a single legal entity. More often, the personnel, infrastructure and processes that make up these internal capabilities are spread across disparate pieces of a company, multiple entities and	internal capabilities as “a business” is in name only. For these reasons, typical requirements of an M&A carve-out transaction, such as requiring a financial statement or a sufficiency of assets representation, are often impractical, if not impossible in lift-out transactions; and a significant degree of analysis, both legal and financial, and ultimately negotiation, is required to properly define the internal capabilities being transferred. potentially even different business units.
---	--

An important aspect of most lift-out transactions is the description of “the business”, in other words, what internal capabilities is the service provider acquiring from the company that will be used to provide services back to the company (and eventually the	Furthermore, the internal capabilities have typically never been commercially exploited and are rarely subject to the types of procedures and performance standards of a commercial offering. As a result, referring to these
---	---

instances such obligations and requirements may unwind the parties arrangement in the other agreement. For example, an obligation of the service provider in the outsourcing agreement to indemnify the company for third party infringement claims in connection with the services may be unwound if the company is representing to the service provider in the purchase agreement that the assets being purchased by the service provider do not infringe on a third party's rights. Moreover, the parties are often focused on the liabilities the service provider is assuming under the purchase agreement, and its ability to recover those liabilities under either the purchase agreement or

purchase agreement, or is it an ongoing expense that the service provider can seek to recover through its pricing under the outsourcing agreement? Either of these options may make sense depending on the specific lift-out transaction, but the failure to coordinate between the documents as to how this obligation is addressed can lead to an inadvertent benefit to either the service provider or the company. As such, it is critical that attorneys negotiating lift-outs carefully coordinate the negotiations of the obligations and liabilities among the various agreements. the outsourcing agreement. Consider for instance a typical employee-related obligation in a carve-out transaction such as

accrued paid time off. Is

Indemnification/Representation Coverage
accrued time off valued as debt, for which the service provider should obtain a purchase price adjustment under the

Another critical aspect of

most lift-out transactions

is the interplay between the purchase agreement

© 2020 Gibson, Dunn & Crutcher LLP. All rights reserved. For contact and other information, please visit us at www.gibsondunn.com. | www.gibsondunn.com

tension between the indemnification provisions in the outsourcing agreement, and how much indemnification and representation coverage the service provider should be provided under the purchase agreement. Often service providers will demand more coverage than usual under a typical carve-out transaction because of the inherent limitations on the service provider under the outsourcing agreement. Moreover, in many lift-out transactions, the outsourcing agreement imposes certain limitations or even prohibitions on who the service provider may provide services to using the purchased capabilities, further limiting the service provider's upside on the arrangement. Companies on the other hand will demand less coverage than usual

selling the internal capabilities at book-value, with little to no premium, or even at a loss. As the company is not making money on the sale of the internal capabilities, and the service provider is not paying for the goodwill or going-concern value of the internal capabilities, the company will often seek to limit its indemnification exposure under the purchase agreement. Achieving the correct balance between the two competing positions is critical to the success of these arrangements. Too one-sided in either direction can achieve the short term goal of a party under the purchase agreement, but can undermine both parties' long term goals under the outsourcing agreement. under a typical carve-out transaction due to the fact that they are often

One of the more
Transitional Services
complicated areas in a lift-out transaction is the

perform the services. Once the inventory is documented, the parties then need to agree-on a detailed implementation plan for each, person, piece of infrastructure and process that is being transferred to the service provider, as well as identifying any gaps in people, infrastructure and processes that the service provider will need to solution, and the plan for addressing those gaps. The implementation plan should ideally be documented and agreed to in sufficient detail prior to contract signing, or at the latest, prior to closing. Otherwise, even minor discrepancies in the parties' understanding as to how particular people, infrastructure or processes are transferring (or not) can have significant impacts on the pricing of the outsourcing aspect of the transaction.

various people, infrastructure and processes (including third party services and contracts) that the customer uses to

The foregoing is a sample of the complex issues that arise in connection with the negotiation and documentation of the purchase aspects of a lift-out transaction. There are similar complex issues that arise in connection with the negotiation and documentations of the outsourcing aspects of the lift out arrangement as follows.

Pricing

As with most carve-out transactions, the service provider in a lift-out transaction will often need the company to continue to provide the services for a period of time following the closing until the service provider can successfully transition the people, infrastructure and processes to its own systems. However, in a lift-out transaction this standard arrangement for a carve-out transaction can become circular, as under the outsourcing agreement the service provider is providing these same services back to the company. To avoid the situation where the company provides

transitional services to the service provider who provides services back to

the company, the parties

companies are looking for their service provider to accommodate the inevitable changes that arise in the company's own product and provider. service offerings. Given the complexity of these transactions, rarely does the pricing model fit neatly into a typical

While lift-outs are driven by a variety of business drivers – such as outsourcing pricing model

Limits on Liability (e.g., fixed fee, variable unitized fee, or time and materials). Instead, the rarely are the parties able to agree to a straight-forward liability structure. More often, the liability pricing models. Often the structure for lift-out transactions is a complex combination of into account increases in the cost of raw materials, people, infrastructure and labor and other service inputs, and efficiencies the customers, but also recognizing that the service provider will innovations in the modify, evolve and processes comprising the potentially even replace internal capabilities or sunset these assets transferred to the service over time once in the possession of the service provider, and include numerous separate caps and baskets for certain types of liabilities, and carve-outs to the consequential damages waiver for certain liabilities.

came, in large part, from the company. Moreover, given the critical nature of the services provided

The liability provisions in

typical outsourcing arrangements often involve the most comprehensive governance process is negotiation, and lift-out critical in most outsourcing transactions; different. However, most and this is equally, if not more, important in a lift-out transaction. The decision making standard construct processes under the whereby the service outsourcing agreement provider will seek to limit its liability for direct enable the company to damages to a function of respond quickly to market the fees paid by the changes, similar to the company under the manner in which the outsourcing arrangement, and have the company respond prior to the lift-out. A number of elements often contribute to an efficient and well for lift-out effective governance transactions. Especially process. First, the given the fact that the governance model people, infrastructure and should identify the roles both parties will maintain provide the services and describe with as much precision as possible the responsibilities of those roles.

Second, contractually requiring a regular meeting cadence is important. Third, the parties should include an efficient dispute resolution process to address operational issues, before they become impediments to the transaction's success. By providing a strong governance process upfront and addressing these and other key issues in advance, the parties to a lift-out transaction can provide a mechanism that will allow the parties to resolve future disputes when they do inevitably arise.

Exit Rights

Whether due to the arrangement's natural expiration, poor performance by the service provider, or a change in strategy by the company, exit rights vary dramatically transaction to transaction depending on the type of internal capabilities transferred, and when in the life-cycle of the arrangement the arrangement is terminated. In anticipation of the potential for a termination of the arrangement, the parties should establish in the outsourcing agreement the appropriate distribution of assets, including people, facilities, IP rights and

processes and determine whether the company will have the right to take back any of the capabilities transferred to the service provider under the purchase agreement. In almost all cases, given the complexity of these arrangements and the interdependencies between the services provided by the service provider, and the success of the company's own business, the parties should provide for a significant transition period in the event the arrangement is terminated for any reason.

Daniel Angel

Co-Chair,
Technology Transactions Practice
New York
+1 212.351.2329
dangel@gibsondunn.com

Dennis J. Friedman

New York
+1 212.351.3900
dfriedman@gibsondunn.com

GIBSON DUNN

the U.S., EU and Asia
dedicated to assisting
customers on these and
related outsourcing matters.
Please contact the Gibson
Dunn attorney with whom you
usually work, any member of
the firm's [Strategic Sourcing
and Commercial Transactions
Practice](#), or the authors.

Please note that we have only
highlighted some of the issues
Attorney Advertising. The enclosed materials have been prepared for general
informational purposes only and are not intended as legal advice.

these complex transactions.

Related Capabilities are
available. Solicitors in
[Strategic Sourcing and Commercial Transactions](#)
[Technology Transactions](#)
addressing any questions you
may have regarding these
[Mergers and Acquisitions](#)

transactions. We have a team
of experienced partners across